Russian and East European Finance and Trade, vol. 36, no. 1, January–February 2000, pp. 7–27.

ISSN 1061–2009/2000 $9.50 + 0.00.

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Priorities of Reform

Ukraine gained independence in late 1991, but its economic reforms were partial and slow. As a result, Ukraine's post-independence economic record has suffered. In the fall of 1994, our country embarked upon the only alternative that could ensure its survival, radical economic reforms, but the reform drive petered out after barely a year.

The purpose of this article is, first, to look back at the reform experience in Ukraine, pinpointing the key elements of an initially successful reform effort in 1994–95. Next, we shall briefly touch upon the nature of the reform reversal from the summer of 1995 until the summer of 1998. The dire consequences of the slowdown of reform were further aggravated by the Asian and Russian financial crises in 1998, as both international finance and export markets dried up. They drove Ukraine not only to fiscal retrenchment but also to some long needed reforms. The third purpose of the article is to try to look beyond this crunch and outline the future tasks of Ukrainian economic reforms. Finally, we shall discuss what kinds of international assistance may be helpful to future Ukrainian reform efforts.

This article will be published as a chapter in the forthcoming book *Economic Reform in Ukraine: The Unfinished Agenda*, ed. Anders Åslund and Georges de Ménil (Armonk, NY: M.E. Sharpe, 2000).

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The History of Ukrainian Reforms

In the history of post-communist economic reforms, Ukraine will stand out as a typical example of a late reformer. Fortunately, the establishment of democracy made possible the election of President Leonid Kuchma and a peaceful transfer of power in 1994. However, the delay of reforms created many lingering problems. In the first years of independence, little reformist legislation was adopted. Meanwhile, unreformed Soviet-like institutions were established at the expense of market-oriented institutions. As an effect of economic distortions, beneficiaries of the market malformations were reinforced and they were able to oppose reforms. Rent seeking evolved, particularly in subsidized credits, metal export regulations, and the regulation of gas imports. Delayed market economic institution building is perhaps the highest cost of late reforms. A potential positive effect of the delay was the Ukrainian population's realization that economic hardship stemmed from the lack of reforms. Hence, the attitude toward a market economy has become much more positive in Ukraine than in Russia, although Russia has seen more of a market economy than has Ukraine.[1] Ukrainians have learned the hard way that a market economy is necessary.

When the Ukrainian economic reforms were finally launched, they appeared to be a textbook case of reform. All the essential elements of success seemed to be present. The first step in the Ukrainian economic reforms was the election, on July 10, 1994, of President Leonid Kuchma, who garnered a majority of 52 percent of the votes cast in the run-off against Leonid Kravchuk. Without that election, we might still be waiting for economic reform in Ukraine. President Kuchma ran a campaign that promised economic change, thus providing him with a popular mandate for economic reform. His democratic election gave him the necessary authority and legitimacy to launch a bold reform.

When Ukraine became independent, the old Soviet economic system had already collapsed, but no new economic system was in place. The slow reform brought about hyperinflation in 1993, which caused tremendous social suffering. Ukraine's GDP slump was much worse than Russia's because the latter at least attempted to carry out radical economic reforms. In addition, our economy has suffered because of rising costs of imported energy and the subsequent deterioration in our terms of trade. Today we can see some light at the end of the tunnel, but the bitter truth is that economic recovery can occur only gradually. For a whole decade we have experienced continuous economic decline. The essential reforms were launched in 1994–95. Macroeconomic stabilization actually occurred in the summer of 1996 and privatization has proceeded gradually, experiencing a big breakthrough in 1996. However, the deregulation undertaken in 1994–95 has actually been averted, and that year stands out as the bright period in our economic reforms. Let us assess the accomplishments of that year.

One Year of Profound Reform: 1994–1995

From September 1994 until June 1995, Ukraine undertook extensive reforms in the spheres of liberalization, macroeconomic stabilization, and privatization. In one year, Ukraine caught up with Russia's economic liberalization and carried out far-reaching price deregulation. The big wave of deregulation that occurred in November 1994 resulted in a price hike of 72 percent. The highly successful price liberalization in the agricultural sector reinvigorated the agricultural market. Gradual deregulation has been undertaken only with respect to public utilities and services, namely, rent, household energy consumption, and public transportation, where drastic price liberalization would have harmed the standard of living. Energy prices for enterprises swiftly reached world market levels. In January 1996, prices of communal services and energy for household consumption were raised to a cost recovery ratio of 60 percent; thus, a large share of household income now goes to rent and heating. The government instituted needs-tested targeted support for those experiencing difficulties in paying the new higher rents and communal services fees.

In principle, domestic trade is completely free, but, in practice, old regional wholesale organizations and enterprise associations control the wholesale prices of a variety of goods, particularly food. Nevertheless, since 1995, virtually anything can be found on the Ukrainian market. The tiresome queues are gone and retail prices are far lower in Ukraine than in Russia. Price differentials among the regions are also much lower in Ukraine, suggesting the existence of true competition and a real market.

In the fall of 1994, Ukraine had a number of widely differing exchange rates, with large state subsidies going to those least in need, in particular to major importers of energy. Today, we have a unified exchange rate set by the market, and all privileges such as cheap hard currency have been abolished. The official exchange rate is determined by the volume of trade on the Kyiv interbank currency exchange, which has been opened to all legitimate participants. Trading has become a daily operation, with several currencies being traded and an increased volume of trade. Importers can obtain their currency legally at a market price and exporters no longer need to hoard hard currency. As a result, the interbank and the street exchange rates have virtually merged, thus unifying the exchange rate. The previously prominent barter in foreign trade has dwindled to less than one-tenth of all foreign trade transactions, essentially representing energy trade with Russia.

Formally, Ukraine has a very liberal import regime without any quantitative restrictions on imports. On average, import tariffs are only about 5 percent, although a few commodity tariffs are as high as 60 percent. For fiscal reasons, it would be desirable to raise the average tariff to at least 10 percent and then to lower some of the higher duties. Exports have also been liberalized and all export quotas and licenses abolished. The last to go was the export quota for grain in the fall of 1995. At the beginning of 1996, the practice of registering export contracts was discontinued along with indicative prices for exports because both policies proved to be unacceptable barriers to our exports.

In October 1994, Ukraine launched a serious attempt at financial stabilization. Unlike previous attempts, this was a full-fledged effort involving fiscal policy, monetary policy, and liberalization, which was supported by the International Monetary Fund (IMF) and substantial international financing. The budget deficit shrank radically from 9.1 percent of GDP in 1994 to 3.2 percent of GDP in 1996, according to IMF definitions. In order to achieve this, unnecessary enterprise subsidies, price subsidies, and capital investments were severely reduced, while all other expenditures were capped. Total public expenditures were reduced from 41.9 percent of GDP in 1994 to 37.8 percent of GDP in 1995; that is, they were cut by over 4 percent of GDP in a single year.

The Ministry of Finance almost succeeded in its overall endeavors, but it accomplished its goal through cash management, that is, through ad hoc cuts in expenditures not budget policy. Far too many expenditures are being disbursed, for example, enterprise subsidies and credits to big industrial units, even though such expenditures have not been included in the budget. At the same time, planned social expenditures have fallen short of targets and substantial budget arrears have accumulated. In the future, the disbursement of pensions, wages, and necessary social expenditures should be given priority over enterprise subsidies.

The process of tax collection continued to function well, but tax rates remained too high, in particular, payroll taxes of 51 percent and income tax rates at a maximum of 40 percent. As a result of high taxes, tax evasion remains massive and a vast share of the Ukrainian economy—roughly 50 percent of GDP—has been driven underground. Police measures are not sufficient to reduce the size of the shadow economy. Ukraine badly needs a fundamental tax reform to reduce tax rates and simplify the tax system, and thus to broaden the tax base.

The monetary policy has, on the whole, been restrictive and responsible since the end of 1993, but it could not succeed on its own without the corresponding fiscal restraints. The National Bank of Ukraine (NBU) has generally adhered to its quarterly credit ceilings, although monetary emission has been uneven and real interest rates have generally been prohibitively high. As inflation has fallen, while the NBU was able to reduce its refinance rate substantially, it has nevertheless remained very high. Another encouraging development was that the government began nonmonetary financing through the sale of treasury bills. The problems in the banking sphere were at the micro rather than the macro level. It is the task of the NBU to promote the development of all kinds of financial markets while improving bank supervision so that under-capitalized and poorly managed banks can be weeded out.

During 1995, Ukraine had a freely floating exchange rate, and the NBU managed to mitigate fluctuations without particularly large interventions, with the exception of one in August, when the exchange rate temporarily dropped sharply. For the year as a whole, the street exchange rate fell from Kb 143,000 per 1 USD to Kb 180,000 per 1 USD, and the floating exchange rate remained at about the latter level. This decline was less than the increase in prices over the same period. Consequently, in real terms, our currency has appreciated, which is a sign of recovery and growing strength. As a result of the combination of a strict fiscal policy, a firm monetary policy, and a unified exchange rate, it became possible to introduce the hryvnia as a permanent national currency in September 1996. As Ukraine no longer had any monetary overhang, there was no need for any confiscation and people could freely and calmly exchange all their currency at an equal conversion rate. Public confidence grew so strong that the exchange rate remained stable after five zeros had been eliminated. This stability generally prevailed until the Russian financial crisis hit Ukraine in September 1998. In effect, the currency reform was only a denomination that capped the stabilization.

As a result of our stabilization efforts, monthly inflation fell from 72 percent in November 1994 to 4.6 percent in May 1995. However, it did not fall further. In September monthly inflation soared to 14.2 percent, then fell to 4.6 percent in December and increased again to 9.2 percent in January 1996. This rise was largely an effect of administrative price increases and an inflow of foreign capital—basically a good sign—but the immediate effect was the exchange of that hard currency into Ukrainian currency, which expanded the domestic money supply. Then, in June 1996, inflation fell to zero, and in 1997 it was only 10 percent for the whole year.

Ukraine faced a dismal shortage of international financing. The underlying problem was the country's structural balance of payments deficit, caused by the deteriorating terms of trade after independence. Because Ukraine now has to pay world market prices for our energy imports, the country has amassed large arrears to Russia and Turkmenistan, which, in turn, has led to repeated cuts in our supplies of natural gas. The Ukrainian government decided to put its international finances in order without allowing its foreign debt to increase as a share of GDP.

The IMF helped us to sort out our international arrears, first through the October 1994 agreement concluded between Ukraine and the IMF on the Systemic Transformation Facility, followed by the April 1995 full-fledged stand-by agreement. Because of its large arrears, Ukraine had a gross financing gap of no less than $4.7 billion in 1995, although total foreign debt was small by international standards ($7.1 billion at the end of 1994), which allowed more money to be borrowed. After considerable efforts, the government successfully mobilized the necessary financing on good terms and minimized the country's foreign arrears.

Ukraine's financing came essentially from four sources: the IMF, the World Bank, Russia, and Turkmenistan. The IMF and the World Bank disbursed $1.2 billion and $400 million, respectively. Russia rescheduled arrears of $2.3 billion and turned them into regular state debt with longer maturity, and Turkmenistan rescheduled $700 million, while the $260 million and $150 million in balance-of-payments support, pledged in 1995 by the European Union (EU) and Japan, respectively, arrived much later.

Fortunately, our balance of payments turned out much better than expected, thus enabling us to avoid additional borrowing. By the end of 1995, our foreign debt had grown moderately to $8.1 billion—still a low figure—representing only 22 percent of our GDP and about a half of exports. Due to the real appreciation of our currency, foreign debt as a share of GDP was smaller in 1995 than in 1994. In 1994, many argued that Ukraine would not be able to attract the necessary international financing, while others thought Ukraine would acquire an excessive debt burden. Both predictions were wrong at the time, but, because Ukraine's economic policies have not as yet delivered the necessary growth, this problem has recurred.

Privatization was complicated because the first three years after independence were squandered. The prolonged debate resulted in a complex and uncoordinated array of laws that further complicated the process. In addition, enterprises lacked true masters, and the insiders who often seized control as informal owners are now reluctant to relinquish their stakes. Nevertheless, more enterprises were privatized in 1995 than during the three preceding years of Ukrainian independence. By the end of 1995, a total of almost 25,000 enterprises had been privatized.

Unfortunately, much of the actual economic activity remained unregistered, which makes it difficult to assess developments in the real economy. From 1991 to 1994, officially, real GDP fell by 47 percent and in 1995, by another 12 percent. However, these figures do not include many expanding private activities as well as the underground activities of state-owned enterprises. A reasonable estimate is that some 40 percent of real GDP is unregistered, and an even greater share of private monetary incomes remains unreported.

Statements that Ukraine's economy never underwent any real structural reform are not quite correct. Massive structural transformations have taken place and the entire enterprise structure has changed. Under communism, small enterprises were scarce, but by 1999 over one million individual entrepreneurs had been registered and tens of thousands of new small businesses were operating throughout the country. Although most large enterprises are witnessing a decrease in production, the Kyiv brewery Obolon and the two largest chocolate factories boosted output by 40–50 percent in 1995 as a result of increased consumer demand for their products. This shows that our economy is able to increase the production of goods for which there is real demand.

In the old communist days, both shops and goods were few and people had to queue for hours. Today, the queues are gone. Prices are, unfortunately, higher in many cases, but people can find what they want and service is much improved. Thousands of new shops have opened, and they are stocked with all kinds of high-quality commodities that were never available under communism. The trade sector, which is at the heart of every market economy, has evolved significantly, and producers now receive much stronger signals about consumer preferences.

Communism was the economic ideology of waste. Massive investments were made, but the return was small in view of wasteful investments that went to industry rather than to the promotion of overall economic welfare. Today, because the government no longer finances enterprise investment, companies must use their funds wisely. Similarly, energy use in production used to be extremely inefficient. It is encouraging that energy imports from the former Soviet Union have declined substantially since independence, although energy consumption has not decreased as rapidly as production. In the future we need to raise the level of energy intensity considerably by making enterprises pay for their energy needs at real market prices.

Our foreign trade did reflect positive structural changes. Ukraine's exports expanded by 37 percent in real terms from 1991 to 1996. However, this expansion has not been maintained: in 1996, the trade deficit rose sharply beyond what we could afford. Our foreign trade has become much more diversified, in terms of both enterprises and products. Trade with the former Soviet Union has decreased, while trade with the West has grown substantially, which reflects a desirable geographic diversification and an adjustment to the market situation, as well as a significant decline in our energy consumption.

Because inflation was much higher than the devaluation of the Ukrainian currency, the karbovanets went through a substantial real revaluation from 1993 until 1998. Therefore, the average wage in Ukraine (measured in dollars) rose from $25 in December 1994 to about $60 in December 1995, thus improving the international material standing of our workers. The real wage statistics are among the most unreliable, because a large and presumably varying share of private incomes is not reported. Even so, the official real wage increased sharply, by 16 percent, in the course of 1995. This figure shows that the standard of living did not slump with financial stabilization, but, on the contrary, it rose. An hour of work bought more goods at the end of 1995 than it did at the end of 1994.

Official unemployment remained negligible at 0.4 percent, but real open unemployment was about 5 percent. The most serious problems are underemployment, falling labor productivity, and poverty stemming from inadequate pay. While many state enterprises produce little, their management refuses to lay off workers, preferring to keep them underpaid or unpaid. People get by through jobs and incomes on the side and many are sustained by their private plots. Apart from some strikes by the coal miners in the East, the Ukrainian labor market has been relatively calm.

The Reversal of Economic Reforms: 1995–1998

Beginning in the summer of 1995, the sense of crisis and energy that had inspired reforms in 1994–95 evaporated for various political reasons involving divisions within the government as well as resistance from a majority in the Parliament. The old vested interests managed to dig into the new ruling team. Price stabilization continued and was completed in 1997, as inflation fell to 10 percent that year. Privatization was always complicated, but it was maintained at a reasonably rapid pace through 1998. However, the necessary systemic reforms were not carried out, and a number of important reforms that had been implemented in 1994–95 were actually reversed.

The worst problems occurred in the sphere of deregulation. One of the starkest examples was the prohibition of grain exports through a number of means in 1996. Strangely, this was done without any formal decision by the government. An informal instruction from then Prime Minister Pavlo Lazarenko allowed regional governors to prohibit grain exports from their region if they anticipated a grain shortage. A minor statute prohibited the state railways from transporting private grain for exports. Another subordinate statute proscribed the state ports to participate in the private export of grain. As a result, the state grain operators could procure grain at about half the world market price and sell it for private gain. Because many foreign creditors and suppliers had accepted grain exports as collateral, this meant that they could not be paid even by debtors who wanted to pay, which became a major embarrassment. Similarly, in many other fields, overt deregulation at the national level was replaced by covert re-regulation by a variety of government agencies and regional authorities.

An army of inspectors descended upon Ukrainian enterprises and started to inspect whatever they could, seriously hampering the work of the enterprise. While many businessmen paid the inspectors to go away, they generally returned. Numerous enterprises became subject to virtually permanent inspections by a multitude of different state agencies whose inspectors were working only in their own corrupt interest. A view developed that the more somebody earned, the more he would be inspected and thus forced to pay taxes and penalties. Moreover, the inspections and bureaucratic harassment took a great deal of managerial time.

In addition, loosening government discipline was naturally reflected in the fiscal sphere, where the budget deficit grew from 3.2 percent of GDP in 1996 to 5.6 percent in 1997. As a result, Ukraine's agreements with the IMF were repeatedly interrupted. Extensively discussed reforms in the public sector, taxation, social policy, and the energy sector were postponed. Although reforms were stalled, funds from foreign portfolio investors became available at this time, both as domestic treasury bills and Eurobonds, and Ukraine could allow itself to ease up for the time being. However, foreign direct investment amounted to only $3 billion by the end of 1997.

Ukraine was seriously ensnared in a net of bureaucracy and rent seeking. It was not obvious how the country disentangle itself from this cobweb. The situation within the government was complicated enough, but the parliament, inspired as it was by a strong left-wing bloc, suggested remedies that were, in general, even worse.

Ukraine Needs More Radical Reforms

The situation changed instantly at the end of October 1997, as the Asian financial crisis dried up credits for all emerging markets, including Ukraine's. Our country had no time to adjust but was suddenly forced to cut public expenditures by nearly 6 percent of GDP from 1996 to 1997. Because the parliament resisted, this could be done only through a package of presidential decrees adopted in late June 1998. It is significant that the payroll tax was reduced from 51 percent to 37 percent and radical cuts in public expenditures were undertaken.

Ukraine needs a new, real breakthrough for economic reforms. We have shown our ability to undertake serious reforms in 1994 and 1995. The government has won the battle against inflation, which increased to only 20 percent per year after the Russian financial crisis forced us to devalue by 50 percent. Experience has demonstrated that inflation is not beneficial either for economic growth or for the standard of living, and Ukraine no longer has any strong constituency that favors inflation. Throughout the post-communist world we have seen that little or no economic growth occurs until inflation is reduced to under 40 percent a year, which is slightly higher than the current level of Ukraine's inflation. Another achievement is substantial privatization that includes the vast majority of Ukrainian enterprises. The overwhelming problem, however, is that Ukraine has not returned to economic growth, and we know that the problem lies in the frightful bureaucratization of the Ukrainian economy. A large number of substantial measures are needed in order for Ukraine to break out of this stalemate and to provide a growth rate of at least 5–6 percent per year.

Currently, priorities for the future are the key question. In general, the pillars of a market economy have been built, but the regulatory framework is still patchy and often inconsistent. A level playing field needs to be constructed so that domestic competition and new enterprises can evolve along with the expansion of exports and the attraction of foreign investment. These are the prime tasks for the next stage of Ukraine's economic reforms. The following twelve priorities are suggested in the interest of establishing subsequent reforms.

1. The tasks are many and require a well-functioning central government. However, the poor functioning of certain structures

of the Ukrainian government is a multifaceted problem. Ukraine has far too many government bodies, and the branch ministries have not been abolished despite repeated attempts. There is an overabundance of control organs, and their number and staff should be pruned. A minister should have full responsibility for the actions of his ministry. Therefore, his ministry should be in charge of decisions within its sphere of responsibility and he should be in charge of appointments within the ministry. One problem is the lack of division between political positions and civil service, which often undermines the power and responsibility of ministers. In particular, the status of deputy ministers is often poorly defined. All this should be clarified in the context of a civil service law. Moreover, promotions should be based on merit rather than age or political connections. Finally, salaries and other remuneration must be obtained for central government functions so that key state jobs become competitive and employee morale is bolstered. The total number of central government staff in Ukraine is 12,000, which is not high by corresponding international standards. The important factors are the organization and competence of the staff rather than their total number.

2. Ukraine lacks a sufficient number of staff educated in law, economics, business administration, and various social sciences. Education in such disciplines is required in capitalist ministries, at universities, and in enterprises. Therefore, thousands of new cadres need to be trained. To date, educational efforts to the benefit of the transition have been focused on short courses, but we now know this is not enough. A large-scale effort is needed to train thousands of new cadres in top-level education both abroad and at new or improved institutions in Ukraine. The aim should be full-scale degree courses, especially doctorates in economics and master degrees in business administration.

3. While basic formal liberalization has made great strides, reality contrasts sharply with the formal situation because of many minor regulations. Numerous additional measures are needed to implement the desired degree of liberalization and to boost competition. It remains difficult to open an enterprise; the excessive and duplicate licensing of new enterprises should be abolished. According to the

Law of Ukraine "On Entrepreneurship," adopted in the summer of 1998, it should be enough to register one enterprise with one state authority. Unfortunately, numerous subordinate decrees and administrative rules contradict the law and are allowed, in practice, to overrule it. Similarly, Soviet-style decrees that continue to regulate domestic trade in impermissible ways should be corrected. Foreign trade remains subject to excessive bureaucratic red tape and interference by authorities. The rights of both central and local authorities to regulate and inspect enterprises must be curtailed.

4. Ukraine's large underground economy poses a serious concern. While a black economy might be a beneficial addition, it is always more inefficient than a legal economy. Considering that only limited elements of the underground economy are outright criminal, it must be brought into the open. It is largely a reflection of the repressive tax system, which demonstrates the need for further tax reform. While the introduction of a single lump-sum tax for individual entrepreneurs has enticed one million to come out into the open, there are probably two million underground entrepreneurs. The aims should include: limiting the number of taxes, setting a ceiling on the tax burden, simplifying the tax system, lowering the tax rates, broadening the tax base, improving collection, and safeguarding the legal security of taxpayers. A great number of people prefer to be honest when honesty becomes economically tenable. Value-added tax (VAT) and profit tax should be defined in accordance with international standards, so that VAT really applies to value added and profit tax to real profit. It is a good thing that the payroll tax has been reduced from its original 52 percent to 37 percent, but, to stimulate the creation of new jobs, it should be reduced to some 30 percent. Nobody pays the maximum income tax of 40 percent and it could be halved without any damage to public finances. Lump-sum taxes for small entrepreneurs should be further promoted through more stable rates. In order to improve the legal security of taxpayers, they should be given the right to complain not only through an administrative process but also through appeal to the courts. In addition, a clearer line must be drawn between the fiscal responsibilities of the central government and those of the local governments.

5. The government has succeeded in bringing budget expenditures reasonably close to state revenues. The budget deficit must be kept low, as monetary policy will have to remain strict. Moreover, a strict fiscal policy is necessary to make possible reasonably low interest rates without provoking inflation. The structure of public expenditure remains haphazard. Three central problems remain. The budget still contains too many enterprise subsidies and other expenditures of limited utility. Neglected social tasks, such as education and health, should receive a larger amount of resources. Recently, treasury control has improved budget execution, but budget consistency needs improvement. If the government cannot afford certain activities, real cuts must be made. While it is notable that government expenditures have fallen, the number of government employees has only slightly decreased. For instance, in the health-care sector, an ever-greater part of government expenditures goes to salaries rather than to medicine and other necessary allowances.

6. Dominant private ownership is vital for the long-term success of reforms. Most Ukrainian small enterprises, many large and medium-sized enterprises, and a large part of the housing sector have already been privatized. Now attention can move to three remaining privatizations: strategically important enterprises, commercial real estate, and land reform. As long as commercial real estate is largely state-owned, its supply is scarce, which blocks the development of new enterprises and causes excessive office costs.

Major enterprises like Ukrtelekom and the big power utilities remain state-owned. The privatization of these enterprises should be able to attract hundreds of millions in foreign direct investments, if fair and transparent public tenders are organized.

Land reform, vital for successful agriculture, tends to occur where land is important to the economy—in countries such as Albania, Romania, Armenia, and Georgia. Agriculture remains both important and a source of potential affluence in Ukraine. Therefore, Ukraine should be able to undertake land reform earlier and more rapidly than Russia, especially because Ukrainian agricultural trade has been liberalized more than Russia's. Now is the time to carry out land reform. The old agrarian establishment must no longer be allowed to stop this reform that is so vital to the well-being of our country. Moreover, private real estate and land will provide ample collateral that will stimulate the evolution of a banking credit system, which, in turn, will stimulate the development of small private enterprises.

7. As the Ukrainian economy starts recovering, access to foreign markets becomes a central issue, making it important to devote more attention to opening Western markets. The relevant spheres are the world market, the EU market, the U.S. market, the Central European markets, and the CIS markets. The key would be for Ukraine to become a member of the World Trade Organization (WTO). Unfortunately, the WTO is a very bureaucratic and slow organization. In its tardiness, the WTO stands in sharp contrast to the IMF and the World Bank, which accepted most of the former Soviet republics as members in the spring of 1992. The slowness of the WTO and its disregard for the former Soviet republics should become a matter of international concern.

In the meantime, Ukraine could try to become a member of the Central European Free Trade Association (CEFTA), which embraces most of former communist Central Europe. CEFTA will open the Central European markets to Ukrainian exporters as well as bring Ukraine closer to EU markets.

The EU is a vital market for Ukraine: two-thirds of Ukraine's total exports are sensitive according to EU definitions (metals, agricultural produce, chemicals, and textiles). Ukraine can easily be excluded from the EU market through common antidumping actions, with a simple antidumping investigation easily capable of throwing a Ukrainian exporter into bankruptcy. Therefore, the Ukraine should make the facilitation of an early and favorable trade agreement a priority in its relations with EU.

While trade with Ukraine may not become very substantial for the United States and Canada, this is all the more reason for the United States to set a free-trading standard by offering Ukrainian exporters extensive access to the U.S. market. However, in this regard, Ukrainian exporters face problems similar to those on EU markets. Russia remains Ukraine's largest market. Even now, Russia purchases about 40 percent of all Ukrainian exports. Ukraine must try to keep trade with Russia as free as possible.

8. The banking system is the circulatory system of a capitalist economy, but the Ukrainian banking system is still rather rudimentary and dominated by five large former state banks. Ukraine requires considerable banking reform based on multiple approaches. Banking is still subject to a large number of administrative decisions, essentially by the National Bank. A reform should guarantee the equal treatment of all decent commercial banks. Some of the administrative mechanisms of interference should be abolished, while remaining permissions should be decided within a reasonable period. Preferably, a few more foreign banks should be given full license to operate in Ukraine as a way to raise qualitative standards and competition, thereby facilitating foreign investment. At the same time, the accounts of Ukrainian banks must be improved and made subject to international standards. Bank supervision should be further improved so that substandard banks eventually lose their licenses.

9. The excessive energy intensity of Ukrainian production must be reduced and energy production in Ukraine should be encouraged. The energy sector is in particular need of restructuring. The first task is to make sure that those consuming—or wasting—energy actually have to pay for their consumption. The gas sector must be transformed into a competitive market, which is the only way of eliminating multiple subsidies and nonpayment problems. The problem in the coal industry is that Ukraine continues to produce expensive coal in inefficient or virtually depleted mines. Here, the issue is to stop subsidization and close down inefficient mines as fast as is socially feasible, and this calls for the active role of the World Bank. In the summer of 1999, the parliament finally adopted laws "On Product-Sharing Agreements" and "On Concessions." It is hoped that these two laws will make it possible to attract foreign investors on a large scale to invest in the Ukrainian energy sector.

10. Ukraine needs a well-designed social safety net. The aim of the economic reform is to promote sustained economic growth and a rising standard of living. However, the transition process is

arduous and involves sharp changes in relative incomes. The role of a social safety net would be to support the truly needy sector of society. While social expenditures remain substantial, they are not very well targeted at the poorest segments of the population.

The pension system functions best among the systems of social support in the country because it is centralized and reaches all pensioners. Pensions should be indexed to wages. Because the prices of communal services, household energy, and public transportation rise regularly, the government has introduced a new system of targeted payments to those in greatest need. Social services are the responsibility of local authorities. Therefore, we are gradually transferring all social assets of state enterprises to the municipalities. However, the municipalities often resist taking over this responsibility, which requires them to devote more of their resources to social services, especially childcare.

Ukraine must undertake a fundamental pension reform. The first decision will always be difficult: no country can possibly afford retirement ages of fifty-five for women and sixty for men and, at the same time, decent pensions. Since the aim should be to support those who are most needy, the retirement age should be raised, preferably after first being equalized for men and women (considering that women live longer) and then gradually raised. However, in order to make this socially acceptable, it is probably better to undertake a more far-reaching reform. A second problem is that pensions are effectively paid for through taxes (the payroll tax) and with savings. This pay-as-you-go system leads to political pressure to raise pensions above a tenable level, and the incentives for savings are insufficient; however, Ukraine will need a high level of savings to accomplish significant future growth. Ideally, only a minimum of pensions should come from the budget. Additional pensions should be based on work undertaken and savings. Independent pension funds could be established as a part of the privatization process. The government could assess its implicit pension debt to certain segments of the population, and it could match certain volumes of pension debt with the assets of utility and telecommunication companies. Hence, new independent pension funds could take over both the pension debt and packages of stocks to finance the pension debt. New pension funds could develop to take care of all additional future pensions above the state minimum. As a consequence, the correlation between work and pensions would rise. Pensions would become more differentiated and cease to be an excessive budgetary burden. Inspired by the example of experience in Chile, similar proposals have been made for many post-communist countries. While none have been undertaken so far, it appears to be a only matter of time before they will be implemented because the more developed countries all face similar problems in financing pensions.

11. Capital markets are vital for the efficient allocation of capital. While they remain rudimentary in Ukraine, now they can begin to evolve. A pension reform could give them totally new significance and life. The two essential early capital markets are the government bond market and the stock market. Ukraine has already developed a treasury bill market, but it remains very thin. The international financial crisis has dealt it a severe shock, but, over time, prices should go up and interest rates down and maturities should increase.

The stock market is more difficult. The government's primary task is not to organize the marketplace but to assure the traders of enterprises' transparency-good accounts and to secure the property rights of the shareholders. While independent share registries have been established in Ukraine, their independence is still in question, slowing down the registration of new owners and stock trading. Minority shareholders' rights need to be reinforced. More basically, a civil code and company law must be promulgated by Parliament. Fortunately, a new law "On Bankruptcy and International Accounting" was adopted in 1999.

12. Well-functioning capitalism must be based on the rule of law. In the long term, the entire legal system must be developed. Many new laws must be adopted; the courts should be strengthened; thousands of lawyers have to be trained. Certain steps can be undertaken swiftly. As a basic demand, only published laws and regulations should be valid. A first step has been taken with the

presidential decree of January 22, 1996, "On the Publication of the Acts of Legislation of Ukraine," but it only requires the Ministry of Justice to publish all norms of law adopted in Ukraine from 1990 to 1995, while many older Soviet laws remain in force. The rights of subordinate government bodies to issue binding regulations must be severely restricted to stop the proliferation of regulations that are unnecessary or harmful.

What Can the Outside World Do for Ukraine?

The list of tasks presented above offers some guidelines for adjusting international assistance to Ukraine. To date, the West has focused on technical assistance to Ukraine. Such assistance has been substantial from the United States, the EU, and a number of Western countries. While the amounts have been impressive, the problem with technical assistance is that almost all of it goes to foreign consultants. Foreign assistance organizations keep a couple of thousand consultants in Ukraine at any given time. In the short term, foreign consultants are important to getting a fast start. However, for a number of reasons, this has failed in Ukraine; moreover, foreign consultants are very expensive. Now we are in for the long haul.

It is time to shift the main emphasis from technical assistance or consultants to the training of young Ukrainians to increase the absorption capacity of the country. We would welcome scholarships for thousands of young Ukrainians at good Western universities, primarily in economics, business administration, and law. We would like them to receive not only short periods of study but full degree courses, particularly doctorates and master degrees in business administration. Simultaneously, resources should be devoted to building up educational institutions in Ukraine, thus providing jobs for returning Ukrainian academics. Sooner or later Ukraine will take off. Therefore, the risk of a brain drain should not be exaggerated. Educated Ukrainians will overwhelmingly return home to earn more.

As Ukrainian reforms proceed, needs vary from aid to trade. As suggested above, the West should focus on facilitating Ukraine's early access to the WTO, and both the EU and the United States should offer Ukraine trade agreements as a mechanism to open their markets to Ukrainian exports.

For the time being, Ukraine remains highly dependent on international financing from the IMF and the World Bank.

There Is No Other Way Out but Real Market Reforms

The delayed start of Ukrainian economic reforms has left a legacy of numerous structural and institutional complications. In particular, the long period of partial reforms has bred a class of rent seekers that thrives on economic distortions and government largesse. These forces have managed to rein in the initially successful reforms of 1994.

A great number of major tasks remains to be solved. This article has emphasized twelve broad tasks: government reorganization; the training of new cadres; further liberalization; tax reform; budget reform; the privatization of strategic enterprises, land, and commercial real estate; the opening of Western markets; bank reform; energy sector reform; pension reform; capital market development; and the development of the rule of law.

As far as international assistance is concerned, Ukraine's acute shortfall of international finance continues to be severe, but support from the IMF and the World Bank remains vital, and, at the same time, we hope to attract more private foreign direct investments in the near future. Because so much time has passed, technical assistance should increasingly be replaced with assistance for the training of young Ukrainians at good Western universities in subjects neglected under communism but vital to capitalism. The new focus of Western dealings with Ukraine should be the swift opening of Western markets to Ukrainian exports.

Note

1. European Commission, *Eastern and Central Eurobarometer*, 1995.